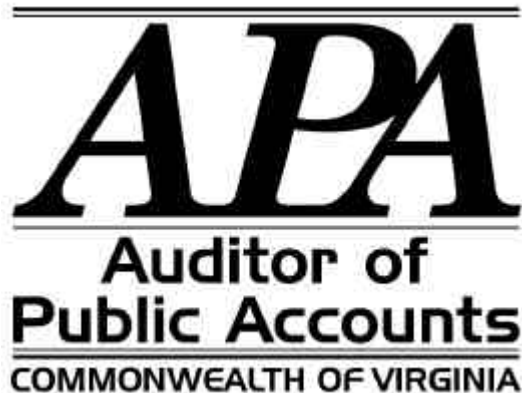


**DEPARTMENT OF HUMAN RESOURCE MANAGEMENT
RICHMOND, VIRGINIA**

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2001**



AUDIT SUMMARY

Our audit of the Department of Human Resource Management, including the Commonwealth Health Insurance Fund, for the year ended June 30, 2001, found:

- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System;
- no internal control matters that we consider material weaknesses;
- no instances of noncompliance with applicable laws and regulations that are required to be reported under Government Auditing Standards; and
- the current reserve balances for the Health Insurance Fund continues to be below the actuarially recommended amount.

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AGENCY OFFICIALS

December 15, 2001

The Honorable Mark R. Warner
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Kevin G. Miller
Chairman, Joint Legislative Audit and
Review Commission
General Assembly Building
Richmond, Virginia

INDEPENDENT AUDITOR'S REPORT

We have audited the financial records and operations of the **Department of Human Resource Management, including the Commonwealth's Health Insurance Fund**, for the year ended June 30, 2001. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

Audit Objectives, Scope, and Methodology

Our audit's primary objectives were to review the Department and Health Insurance Fund's accuracy of recording financial transactions on the Commonwealth's Accounting and Reporting System, adequacy of internal control, and adequacy of reserve balances and to determine compliance with applicable laws and regulations.

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of operations. We also tested transactions and performed such other auditing procedures as we considered necessary to achieve our objectives. We reviewed the overall internal accounting controls, including controls for administering compliance with applicable laws and regulations over the significant cycles, classes of transactions, and account balances: accounts receivable, receipts and expenses, claims payable, and contract administration.

We obtained an understanding of the relevant internal control components sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. We performed audit tests to determine whether the Department's controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations.

Management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Our audit was more limited than would be necessary to provide assurance on internal control or on overall compliance with laws and regulations. Because of inherent limitations in internal control, errors, irregularities, or noncompliance may nevertheless occur and not be detected. Also, projecting the evaluation of the internal control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, or that the effectiveness of the design and operation of controls may deteriorate.

Audit Conclusions

We found the Department properly stated, in all material respects, the amounts recorded and reported in the Commonwealth's Accounting and Reporting System. The Department records its financial transactions on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

We noted no matters involving internal control and its operation that we consider to be material weaknesses. Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to financial operations may occur and not be detected promptly by employees in the normal course of performing their duties.

The results of our tests of compliance disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

The Department has taken adequate corrective action with respect to audit findings reported in the prior year.

This report is intended for the information of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

EXIT CONFERENCE

We discussed this report with management at an exit conference held on May 31, 2002.

AUDITOR OF PUBLIC ACCOUNTS

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DEPARTMENT OF HUMAN RESOURCE MANAGEMENT HIGHLIGHTS

In fiscal year 2001, the Department of Human Resource Management received appropriations of approximately \$9 million. The Department of Human Resource Management administers the Commonwealth's Personnel Act and health insurance plans for state and local employees. The Department's responsibilities include providing expertise in the areas of compensation, equal employment compliance, health benefits, and human resources policy and training. The Department is also the central source for information about the Commonwealth's employment work force and provides a listing of state employment opportunities.

On July 1, 2000, the Department assumed responsibility for the Workers' Compensation Program from the Department of General Services, creating the Office of Workers' Compensation (OWC). The Workers' Compensation program protects all Commonwealth of Virginia state employees from financial loss due to lost work and wages, medical expenses, and other costs associated with a covered injury sustained in the course and scope of employment.

OWC bills agencies annually for insurance premiums totaling more than \$26 million. Managed Care Innovations has a contract to manage cost containment and claims administration and uses a subcontractor, Frank Gates Service Company, for the third-party claims administration. OWC contracts for an annual audit of the internal control procedures used by the Frank Gates Service Company when processing claims.

HEALTH INSURANCE FUND HIGHLIGHTS

The Commonwealth of Virginia offers state employees and retirees, as well as Virginia localities' employees, the opportunity to participate in a group healthcare program. The program consists of several self-insured plans and seven commercially-insured health maintenance organization (HMO) plans. The self-insured plans offered include Key Advantage, Cost Alliance, and several Medicare supplements.

The Department manages all health insurance programs and uses contractors to perform most of the program operations. The Department's responsibility is to procure these contractors' services and oversee the contracts. They manage the programs through state agencies by developing instructions and training and serve as a resource to agency benefits officers.

Administration of the Commonwealth Self-Insured Plan

The Department has contracted with Trigon and Magellan Behavior Health for the administration of the Key Advantage and Cost Alliance programs. Trigon administers the medical/surgical, dental, outpatient prescription drug, and comprehensive case management programs. Magellan administers the mental health/substance abuse program. Trigon and Magellan receive and pay provider claims, verify participant eligibility against the state's Benefit Eligibility System (BES), and serve as liaisons with health care providers and hospitals. Trigon bills the Commonwealth weekly for all claims processed.

The contracts establish standards of performance for claims accuracy, processing time, and savings due to coordination of benefits with other insurance companies. The contracts require the measurement of performance standards through claims audits and impose monetary penalties for failure to meet the established standards.

The Department contracts with a consultant to monitor claims paid by Trigon. The consultant currently reviews claims for eligibility requirements and produces weekly exception reports. The Department reviews the exception reports and forwards improperly paid claims to Trigon for review and correction.

Reserves

The Commonwealth assumes all risk for the self-insured health insurance program provided to state employees and retirees. If the Health Insurance Fund (Fund) had a deficit, the Commonwealth would have responsibility for paying the outstanding claims. Annually, an actuary reviews the Fund and recommends reserves consisting of three components: incurred but not reported (IBNR), extended benefits, and contingency. The IBNR portion of the reserves uses historical data and represents the amount of claims that the Fund can expect to pay subsequent to fiscal year end. The extended benefits portion differs from the IBNR in that it represents potential claims that are outside the norm. The contingency reserves represent the amount of administrative costs and outstanding claims the Commonwealth would need to pay to close out the Fund.

The actuary recommended reserves for IBNR and extended benefits totaling \$45 million for fiscal year 2001, which the Department fully funded. For fiscal year 2001, the actuary recommended a contingency reserve of \$43,859,545, but the Department has reduced the reserve to \$16,718,881.

The actuary recommends having a contingency reserve as a best practice, even if it is unlikely that the Commonwealth will permanently terminate the Fund. Management believes that it is no longer necessary to have the contingency reserve. Therefore, they have implemented a plan to phase out the contingency reserve portion over time because of the unlikelihood that the Commonwealth will terminate the Fund.

Premium rates were increased July 1, 1998 and January 1, 1999 for all self-insured plans for active and retired employees. Premium rates increased again for all self-insured plans for active employees on July 1, 2000 and July 1, 2001. Despite the premium increases, the Fund had an operating loss in fiscal years 2000 and 2001. The Department has worked with the Department of Planning and Budget to set fiscal year 2002 premium rates and increase the outpatient hospital co-payment to establish adequate funding in the future. Although we project operating losses will continue next year, the General Assembly has designated a sum sufficient to meet claims in the event that the Fund ceases operations and collects no more premiums as stated in the 2000 Appropriation Act.

DEPARTMENT OF HUMAN RESOURCE MANAGEMENT
Richmond, Virginia

Sara Redding Wilson, Director
Department of Human Resource Management

Mary Habel, Director
Office of Health Benefits

Sue Keener, Director
Office of Workers' Compensation